

**DEPARTMENT OF STATE REVENUE
SUPPLEMENTAL LETTER OF FINDINGS: 02-0304SLOF
Indiana Corporate Income Tax
For the Tax Years 1996, 1997, and 1998**

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ISSUE

I. Excess-Value Reinsurance Premiums – Adjusted Gross Income Tax.

Authority: IC 6-3-2-2(l); Bethlehem Steel Corp. v. Ind. Dept. of State Revenue, 597 N.E.2d 1327 (Ind. Tax Ct. 1992); I.R.C. § 482.

Taxpayer challenges the Department of Revenue's decision to include, as taxpayer's own income, reinsurance payments received from taxpayer's customers and subsequently paid to a domestic insurance company and to a foreign insurance business.

STATEMENT OF FACTS

Taxpayer is in the business of shipping packages. The Department of Revenue (Department) conducted an audit of taxpayer's 1996, 1997, and 1998 business records and tax returns. The audit review made a number of adjustments which resulted in an assessment of additional Indiana corporate income tax. Taxpayer protested the audit's conclusions. The Department sustained in part and denied in part taxpayer's protest in a written Letter of Findings. Taxpayer disagreed with the Department's conclusion that the reinsurance premiums – received from taxpayer's customers and paid over to a foreign and a domestic insurer – should be treated as taxpayer's own gross income. The Department agreed to rehear taxpayer's challenge, and this Supplemental Letter of Findings revisits the issue.

DISCUSSION

I. Excess-Value Reinsurance Premiums – Adjusted Gross Income Tax.

When taxpayer ships one of its customer's packages, the package is automatically insured for a base amount. If the customer decides to do so, the customer may purchase additional insurance. This amount charged for this additional insurance is called an "excess value charge."

Taxpayer entered into an arrangement minimizing the potential tax effect on profits obtained from insuring its customers' packages. Taxpayer formed and capitalized a Bermuda corporation. The Bermuda corporation's shareholders were essentially identical to taxpayer's own shareholders. Thereafter, taxpayer bought an insurance policy – on behalf of its excess value

insureds – from a domestic insurance company. The domestic insurance company assumed the risk of damage or loss to customers’ excess value packages. Nonetheless, taxpayer continued to administer the day-to-day claims submitted by its customers.

The domestic insurance company then entered into a reinsurance treaty with the Bermuda corporation. The Bermuda corporation agreed to assume the entire amount of risk borne by the domestic insurance company and owed to taxpayer.

Pursuant to the parties’ agreement, taxpayer collected its customers’ excess value insurance payments, investigated claims, settled verified claims, and paid over the remaining premium amount to the domestic insurance company. The difference between the amount taxpayer received from its customers and the amount of money taxpayer paid for losses, constituted the premiums owed on the policy with the domestic insurance company.

The domestic insurance company accepted the premiums, and – after retaining a portion of those proceeds – forwarded the remainder to the Bermuda corporation as consideration for the reinsurance agreement.

Taxpayer did not report on its federal income tax returns the amount of excess value insurance premiums received from its customers. The Internal Revenue Service (IRS) disagreed with this decision and assessed a deficiency equal to the value of the excess charges taxpayer collected. Taxpayer appealed the IRS decision to the U.S. Tax Court. In a 1999 Memo, that court agreed with the IRS determination concluding that the taxpayer’s insurance arrangement was a “sham.”

During an audit of taxpayer’s state returns, the Department reached a conclusion which closely paralleled the IRS decision. Taxpayer’s state returns were adjusted to include the amount of money taxpayer collected as excess value charges.

After protesting the Department’s decision, a Letter of Findings (LOF) was issued which denied that protest. In that LOF, the Department concluded that the reinsurance agreement came “within the definition of the sham transaction doctrine.” The LOF stated that “it is apparent that the reinsurance agreements were entered into for no independent purpose other than obtaining the tax benefits attendant upon those arrangements and that it is the taxpayer who is earning this [reinsurance] money and not the domestic insurance company and not the Bermuda corporation.”

Having concluded that the reinsurance agreement was a “sham,” the Department found that under IC 6-3-2-2(l), the taxpayer was required to “report the entirety of the excess value premiums as taxpayer’s own income because the taxpayer’s reinsurance agreements have no substantive economic substance or business purpose.” In support of that decision, the LOF cited to Bethlehem Steel Corp. v. Ind. Dept. of State Revenue, 597 N.E.2d 1327 (Ind. Tax Ct. 1992) pointing out that the Department was required to consider “the substance rather than the form of the transaction.” Id. at 1331.

Taxpayer – in its request for a rehearing – has asked that the Department revisit its initial decision in light of taxpayer’s appeal of the 1999 U.S. Tax Court decision to the United States Court of Appeals. In an opinion issued by the Court of Appeals, that court accepted taxpayer’s

contention that the reinsurance agreements were not a “sham” but that the agreements evidenced sufficient economic substance to warrant favorable tax treatment. Having arrived at that conclusion, the Court of Appeals reversed the U.S. Tax Court decision and remanded for a determination of taxpayer’s potential liability under the reallocation provisions of I.R.C. §§ 482, 845(a).

However, during 2003 taxpayer and the IRS reached a settlement agreement regarding federal tax treatment of the disputed excess value premiums. The settlement agreement addressed the I.R.C. § 482 allocation of the excess value premiums for the years at issue. Thereafter, taxpayer submitted information to the Department reflecting the terms of the settlement agreement and tendering payment of its consequent Indiana corporate income tax liability.

The Department concludes that it is required to accept the U.S. Court of Appeals decision that the reinsurance agreements with the domestic insurance company and the Bermuda corporation were not a “sham” and that taxpayer is entitled to the attendant tax benefits. Accordingly, to the extent that the 2003 settlement agreement resolved the I.R.C. § 482 allocation of income from the Bermuda corporation to taxpayer, the Department is prepared to abide by the terms of that agreement.

FINDING

Taxpayer’s protest is sustained.